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National City Monthly Letter on Business and Economic Conditions

New York, September, 1954

General Business Conditions

THE summer with its usual letdown in trade and production has ended and businessmen are looking hopefully to the fall season. For the past six months, the economy has been moving more or less on an even keel, seasonal factors taken into consideration. Industrial production bottomed out in July, and in August indications of seasonal expansion became apparent in many lines. Construction activity rose to a new peak in July, and contract awards covering work to be started ran ahead of a year ago in early August. Retail sales were well maintained, and the general level of prices remained firm.

Plantwide closings in July for vacations and other causes evidently did not cut into total output more than the usual seasonal amount. The Federal Reserve index of industrial production, though down 6 per cent before seasonal adjustment, showed no change on an adjusted basis. The adjusted index has shown remarkable stability since January, varying no more than one point above or below an average level of 124 (1947-49 = 100).

In August, industrial output ordinarily snaps back to approximately the June level. This year apparently was no exception, although output in some important lines including steel, automobiles, and petroleum refining, lagged. Labor difficulties hampered production in other lines. Thus the seasonally adjusted production index in August may slip somewhat below the June-July level.

Influence of Auto Change-over

Steel mill orders so far have proved disappointing. Operations in August failed to improve upon the July average rate of 63 per cent of capacity, compared with 72 per cent in June, as customers continued to buy on a hand-to-mouth basis.

A major factor in the steel market has been lack of demand from the automobile industry pending completion of extensive model changes. The cut in passenger car output during the change-over period will be sharp, much like the prewar pattern. Some producers have already cut back output of 1954 models; others will shortly. Automobile assembly lines, which turned out an average of nearly half a million passenger cars a month during the first half of 1954, produced 435,500 in August and, according to Ward's Automotive Reports, are scheduled to turn out only 282,500 in September. A sharp rebound is due in the fourth quarter, as producers stock up their dealers and launch their sales campaigns for the 1955 models.

Consumers are still in the market for good buys in new and used cars. Sales by dealers were maintained better than expected during the summer, although they fell short of June which was the best month for auto sales in nearly four years. Dealers have been able to cut their stocks,

CONTENTS

and expect to be in a better position when new models come than they were last year.

On the whole, other types of retail sales showed moderate improvement in July over both June and the year ago level. A sustained consumer demand was indicated for August in favorable year-to-year sales comparisons reported by department stores. Retailers continue to express optimism over the course of sales, and some are looking forward to the best Christmas season yet. Buying policies, however, remain cautious; the pattern for numerous lines is apparently the same as last year's — small initial orders to be followed by selective reordering.

Consumer attitudes, according to a midyear survey by the Survey Research Center of the University of Michigan, support an optimistic appraisal of retail sales prospects. The survey finds that most families feel better off financially than they did a year ago, more because of tax cuts than because of increased income. They think that the outlook is favorable and that this is a good time to make major purchases. Nevertheless, retailers find vigorous promotions are still needed to change the vague idea that this would be "a good time to buy" into a sale rung up on the cash register.

Building Still Booming

The string of new records set by the construction industry this year continues to be the most outstandingly bullish feature of the business situation. Construction activity hit an all-time peak in July, as work on commercial buildings, churches, schools, and public works set new records. Private residential building was the greatest since the 1950 housing boom.

No signs of let-up are evident. New dwellings started in July were still at an annual rate (seasonally adjusted) of well over one million for the eleventh consecutive month. Construction contract awards (as reported by F. W. Dodge) for the first half of August ran well above a year ago. Mortgage money is increasingly plentiful in most parts of the country, and the housing bill, signed by the President early in August, is expected to broaden the market for both old and new homes. The bond market has been readily absorbing bond issues floated to finance construction projects for state and local authorities.

Behavior of Inventories

Among the series of indexes to which business men and economists are giving close attention these days are those on inventories published monthly by the Department of Commerce. Optimists on the business outlook point to the steady decline in the inventory totals (seasonally adjusted) from the peak last September as evidence that the process of adjusting production to consumption is making good progress, hastening the day when an upturn in new ordering, production, and employment can be expected.

Pessimists stress the "meagerness" of the adjustment so far recorded, and emphasize the magnitude of the stocks still on hand as compared with figures in times past. They call attention to the fact that as of June 30 total business inventories of $79 billion were, according to Department of Commerce calculations, down only $3 billion, or 4 per cent, from the September '53 high, and still stood half again as large as in 1950 before the outbreak of the Korean war. Such progress is regarded as disappointingly slow — discouraging hopes of an early improvement in general business, and even raising some doubt that a further dip can be avoided.

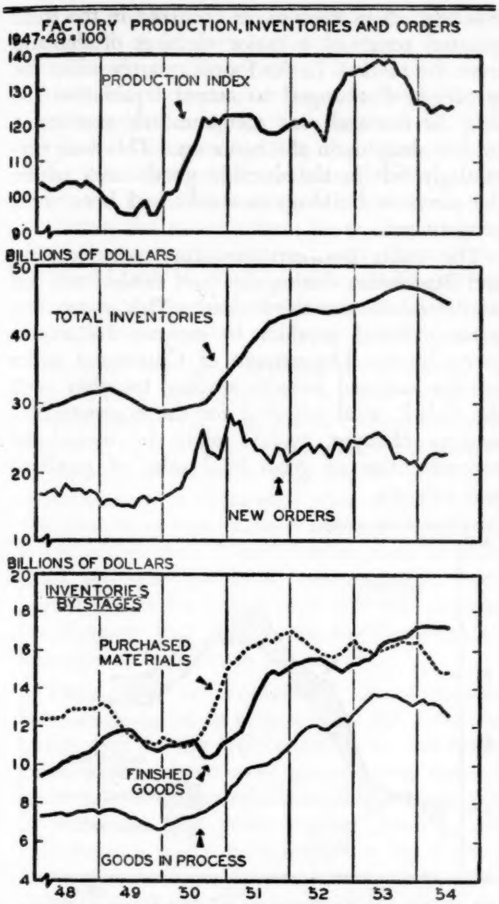
Because of the important role played by inventories in business fluctuations, a brief review and analysis of the figures appears timely. In such a study, comparison of inventory changes with production and new orders, during the current recession and in the 1948-49 slump, is of interest.

Inventory Lag Normal

In the accompanying chart, the two upper panels trace the course of production, inventories, and new orders received in the manufacturing industries as shown by the Commerce Department series for the period January '48 through June '54. The lower panel gives the trend for inventories alone broken down by stages of fabrication.

The main point to be noted in the upper panels is the clear tendency for factory inventory changes to lag behind changes in production and orders. This tendency has been shown by studies of the National Bureau of Economic Research to appear in previous business cycles as well. It takes time to sense changes in business trends, to alter purchasing, production, and selling policies, to complete manufacture and delivery of goods in process, and to take any number of actions which affect inventories.

As will be seen from the chart, in the 1948-49 recession factory production and orders turned down in the latter half of '48, but stocks continued to accumulate until early in '49. Though output and orders reached their cyclical lows in the middle of '49, the decline in inventories did



Sources: Federal Reserve index of manufacturing output and Department of Commerce estimates of dollar totals of new orders received and inventories held by manufacturers. Figures seasonally adjusted except those for inventories by stages of fabrication. Latest production figure July, all others June.

not touch bottom until the following November. This was well after production and orders had turned up.

From this precedent it does not appear abnormal that in the current recession the decline in inventories again lagged behind the downturn in production and orders. Nor would it be surprising if this decline should continue for some time after production and orders turn up. As shown in '49, business revival need not wait upon completion of factory inventory correction. It is partly the business upturn that enables manufacturers to work down their excess stocks.

Inventories by Stages of Fabrication

The behavior of factory inventories may perhaps be better understood by reference to the lower panel of the chart showing manufacturing inventories by stages of fabrication.

Here it will be seen that the decline in total factory inventories this year has been due mainly to a relatively prompt cutback in stocks of purchased materials (including both raw and semifinished goods), and to a lesser extent to decline in stocks of goods in process of manufacture. Stocks of finished goods (including both products ready for final consumption and goods used by other manufacturers for further processing) show as yet little decline.

This, as the chart shows, follows closely the pattern of 1948-49. For those who are concerned about the continued high level of finished goods stocks held by manufacturers, it should be pointed out that such stocks in the past have tended to move in counter-cyclical fashion. Thus in '49 their peak in the middle of the year coincided closely in timing with the lows of output and orders. It was not until after the revival of general demand, accompanied by an upturn in output and orders, that manufacturers as a group were able to make headway in cutting these stocks. Just as in the declining phase of the business cycle hand-to-mouth buying tends to throw the burden of carrying stocks back on the manufacturer, so in the advancing phase more confident buying tends to fill up depleted pipelines and distribute the stocks more broadly throughout the business community.

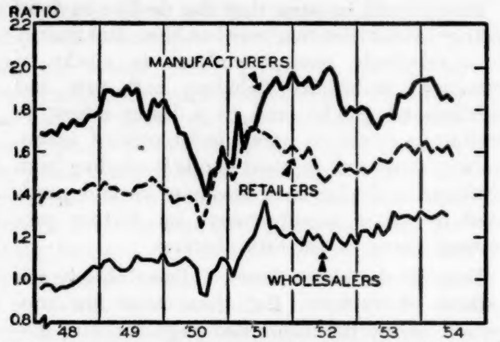
In short, despite an apparent "stickiness" in inventories, actually the process of adjusting production to consumption and working down stocks seems to be going ahead in much the normal way.

Ratios of Stocks to Sales

Nevertheless, in spite of the progress made in reducing inventories, their high level as compared with the past continues to disturb many people and causes them to wonder whether something more drastic in the way of inventory correction may not be required.

It is true, as the chart shows, that inventories, taken by themselves, still look extremely high. But it is also true that most other dollar measures of business, such as sales, orders, and the gross national product, have risen greatly since Korea, reflecting both economic growth and inflation of prices.

When inventories are related to sales, as in the next chart, the picture looks quite different. In the case of manufacturers' stocks the ratios over the past year have not been significantly higher than in comparable periods of 1948-49, and they have been below comparable periods of 1951-52.



Ratios of Inventories to Sales of Manufacturers, Retailers and Wholesalers. Source: Department of Commerce. Latest figures June '54.

Retailers' and wholesalers' stock-sales ratios do show advances as compared with 1948-49. Whether this reflects abnormally high ratios now or abnormally low ratios in 1948-49 is not clear in the absence of earlier data. In general, it appears that retailers' and wholesalers' stock-sales ratios fluctuate less widely than those of manufacturers.

Though all three ratios dipped sharply in 1950, this was the result of rising sales after Korea rather than of inventory cutting. In all three cases the low ratios came at a time when business was scrambling to add to stocks, not trying to get rid of them. Unless it be assumed that the economy in general is to be deflated back to the level of 1950 there is no reason for assuming that inventories alone will be. Certainly the Government could be counted on to oppose such massive deflation with all the powers at its command.

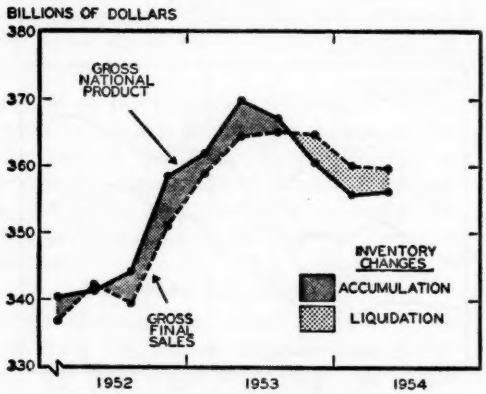
An Encouraging Outlook

The foregoing evidence would seem to support those who take the brighter view of the progress of inventory correction. Judged by the record, the adjustment appears to be running a more or less normal course, encouraging hopes that it may be nearing completion. As may be seen by referring to the first chart, the 1949 inventory decline began in March and lasted through November, a period of nine months. On this basis, the current decline, which began last October, would have been completed about the middle of this year.

What the timing will prove to be in the present situation remains to be seen. But whenever the decline in inventories does level off or change to a net accumulation, the consequences for the economy at large will be important.

During the second quarter of last year, business was adding to stocks at the rate of $7 billion a year (seasonally adjusted), and the mere levelling off in the rise, as occurred in the third quarter, removed a major element of demand from the market. In the fourth quarter when the levelling off changed to actual liquidation the drop in demand was compounded, exerting a further drag upon the economy. This was particularly felt in the durable goods area where the previous build-up in stocks had been most pronounced.

The shifts between inventory accumulation and liquidation during the past three years are illustrated in the third chart. This shows the gross national product in current dollars, as given by the Department of Commerce in its regular national income studies, together with the G.N.P. total adjusted for the computed inventory changes, which might be considered representative of gross final sales of products and services.



Gross National Product, Including and Excluding Inventory Accumulation and Liquidation. Source: Department of Commerce. Latest figures June '54.

As the chart indicates, the 1952-53 rise in gross national product was intensified by inventory accumulation while the recent decline has been accentuated by inventory liquidation.

The chart also suggests how a mere levelling off now in the decline in inventories would remove a brake from the economy, while the beginning of a rebuilding of depleted stocks would act as a positive force in recovery.

More on the Farm Problem

President Eisenhower on August 28 signed the controversial Administration farm bill which, before being passed by the Congress, was subjected to intense and bitter opposition from farm bloc advocates of high price supports. This new legislation, known as the Agricultural Act of 1954, and effective January 1, 1955, includes nearly everything requested by the President in his farm message to the Congress last January.

First, it calls for flexible price supports ranging from 82.5 to 90 per cent of parity on five basic crops — wheat, corn, cotton, rice, and peanuts. This was a compromise between rigid 90 per cent supports expiring this year, and the 75 to 90 per cent range sought by the Administration. Thus the Administration, although failing to get as much flexibility as desired, did succeed in reversing the nation's farm price support policy from the rigid 90 per cent props adopted early in World War II. Tobacco, the other basic crop, was never a source of disagreement and will continue to be supported at 90 per cent of parity.

Second, the new legislation authorizes the President to set-aside and insulate from commercial markets $2.5 billion of surplus commodities held by the Commodity Credit Corporation. Commodities set-aside will not be counted in supplies used to determine price supports under the flexible system, thereby tending to keep supports higher than if such stocks were included. This set-aside provision, covering only cotton and wheat of the basic crops, will ease any drop in supports that may occur in changing from the rigid to the flexible system.

Third, the Act contains a direct payment scheme designed to raise annual domestic wool production in the United States to 300 million pounds on a shorn wool grease basis, from the current level of around 229 million pounds. Wool growers, for four years starting April 1, 1955, will receive direct subsidies from the Treasury for any difference between the average market price of wool and the support price, which must not exceed 110 per cent of parity.

Fourth, the modernized parity formula is to become effective starting January 1, 1956 for wheat, corn, cotton, and peanuts, the only commodities for which parity prices are still being calculated on the basis of horse farming during 1909-14. New parities generally are lower than old parities, but any price drop will be limited to five per cent a year.

Flexible Supports to Have Little Immediate Effect

Although the new farm law provided the Administration with a victory in principle, flexible supports on 1955 crops, except wheat, will approximate present rigid supports at 90 per cent of parity. Wheat is in such oversupply that its support, despite a set-aside of 400 to 500 million bushels, will be at the minimum support of 82.5 per cent of parity. The support on cotton, eligible for a set-aside of three to four million bales, is likely to remain at 90 per cent. Indicated supports for other basic crops are corn, 90 per cent; peanuts, 86; and rice, 85 to 90.

Thus, substantially lower supports are not in prospect until 1956 when (1) flexible supports, demand-supply conditions warranting, could range down to a minimum of 75 per cent of parity, and (2) the lower modernized parity becomes effective for wheat, corn, cotton, and peanuts. Even then, as previously indicated, any price change for these crops will be limited to five per cent annually. All this, of course, depends upon the Congress getting over its old habit of postponing the operation of flexible price supports. With farm price supports a major issue in the fall political campaigns, it is conceivable that the outcome of the elections might determine whether the Congress early next year will push through a high support bill in time for 1955 crops. The chief barrier to such action is the threat of a veto by the President who is firmly committed to flexible supports.

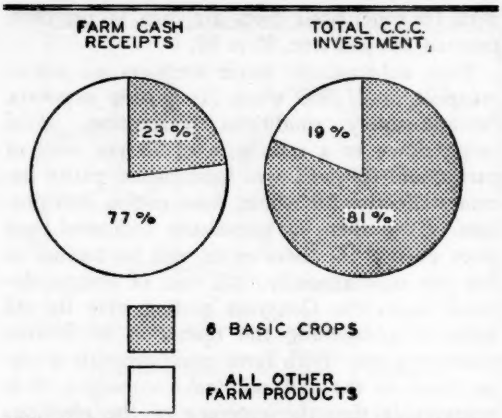
Basic Crops Chief Item in CCC Investment

As discussed in this Letter last month, the vast accumulation of surplus products in CCC hands has created baffling problems for the Secretary of Agriculture. Disposals continue slow and, with CCC price support obligations expected to increase in the months ahead, the Congress last month, acting on a request by the President, raised that agency's borrowing authority by $1.5 billion to a new high of $10 billion. This increase, following a $1.75 billion addition last February, means that the CCC borrowing authority has been raised by nearly 50 per cent this year.

The latest CCC monthly report, as of May 31, 1954, shows that the six basic crops, particularly wheat, corn, and cotton, which have enjoyed high rigid supports and have been responsible for most of the farm bill controversy, are the chief components of the heavy CCC investment in surpluses. This is brought out in the chart.

The chart reveals how the six basic crops, though providing only 23 per cent of total farm cash receipts, constitute the bulk of the surplus problem. This disproportionate relationship points to two conclusions:

One, that assertions by advocates of high rigid supports that flexible props on these six crops will cut farm income drastically are greatly exaggerated. Not only do these crops account for less than one-fourth of total farm cash receipts (in fact some 56 per cent of cash farm receipts is derived from commodities receiving no direct price support whatsoever), but even for these six crops the level of support prices under the pro-



While the 6 Basic Crops Represent 23 Per Cent of Total Farm Cash Receipts, They Represent 81 Per Cent of Total CCC Investment.

visions of the new law will, for most '55 crops at least, not be much affected.

Two, that the opponents of rigid supports are fully warranted in stressing these props as principally to blame for the accumulation of farm surpluses. Of the six basic crops constituting some 80 per cent of the surplus problem, wheat has been the biggest headache, accounting for over $2 billion or one-third of the total CCC investment at the end of May. Although domestic per capita consumption of wheat has skidded to 129 pounds from 160 pounds in 1935-39 and recent exports have dwindled sharply, wheat farmers have continued to produce far in excess of our needs. The question is why farmers should continue to have the incentive of high support prices for products in such low demand.

Similarly, huge CCC stocks of corn show the folly of high rigid supports which cause farmers to grow corn, our leading feed crop, for government storage in lieu of feeding it to livestock. While the overall demand for food is relatively inelastic, there is considerable elasticity in the demand for many foods, such as fruits, meat, eggs, and other livestock products. As pointed out by Dr. W. I. Myers, Dean of the New York State College at Cornell University and Chairman of the President's National Agricultural Advisory Committee, "The principal advantage of converting excess grain into meat and livestock products is that this is the best way of increasing our use of agricultural resources since many pounds of grain are required for a pound of meat." But prices of corn and other feeds must be low enough to make their feeding profitable.

The Old Question of Farm vs. Retail Prices

During Congressional debate on the farm bill, proponents of high price supports contended that flexible supports would not materially reduce prices to consumers or increase the consumption of surplus products. They pointed out that a $3.95 cotton shirt contains only about 30 cents worth of cotton, hence that lowering the price of cotton would mean little in the shirt price. They also contended that with the farm value of wheat in a 1-pound loaf of bread only about 2.5 cents, a drop in wheat prices would have little or no effect on bread.

This argument was well answered in the minority report of the Senate Agricultural Committee. Declaring that "there is enough truth to this statement to make it convincing, and enough untruth to make it dangerous," the report went on to say:

> In the case of many agricultural products, such as livestock and dairy products, fruits, and vegetables – by far the most important source of farm income – the statement that price has little to do with guiding production and consumption is completely untrue. It is true, however, that a lower price for wheat would not increase the domestic consumption of bread. But it would permit us to meet export competition and to move more wheat in the form of livestock feed. A lower price for cotton would permit us better to meet the competition of synthetic fibers. It would permit us to regain a part of the world cotton trade which has been lost to foreign countries with respect to whom we have held a price umbrella.
>
> The housewife chooses food on the basis of price. The foreign buyer of American export products is price-conscious. The textile trade selects its fibers partly on the basis of price. No more effective weapon can be used to drive customers away from our products than to price these products at levels which are out of line with other products or alternative sources of supply.

A growing factor in the farm-retail price spread is that consumers want and apparently are willing to pay for better processing, sanitary handling, and more attractive and convenient packaging of farm products. These services, on top of transportation and marketing charges (all of which have been boosted by rising wages for labor), add much to the final retail price.

High Supports Boost Farm Competition

During the past 15 years, efficient wheat producers have noted with growing concern the increased competition from other domestic farmers and foreign countries. Much land in the Great Plains that should have been kept in pasture and soil conserving crops has, as a result of high support prices, been tilled and used for wheat production. Also, less efficient producers in areas better adapted to other types of farming have shifted to wheat. Typical is the situation in Michigan where wheat has been expanded at the expense of dry edible beans, simply because wheat growing was made more profitable by high rigid supports.

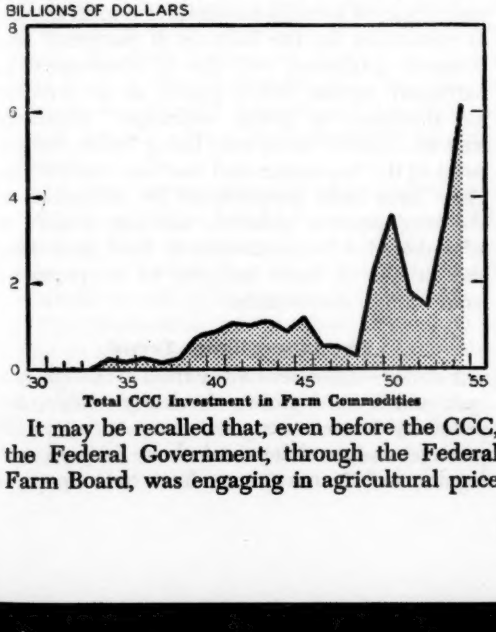
As a consequence, tremendous supplies of wheat are overhanging the market and the Secretary of Agriculture has been forced to invoke the most stringent curbs on wheat production in history. Whereas 78.7 million acres were planted to wheat for the 1953 crop, plantings for next year's crop have been cut to 55 million acres. As Secretary Benson declared: "This is stiff medicine for agriculture and I don't like it. It even involves considerable restriction of the activities of farmers who seek none of the benefits of price supports."

Nevertheless, growers in Michigan and other new areas are demanding their right to grow wheat and as a result the drastic cuts have had to be applied generally, including not only farmers in the newer regions but also the efficient producers in the old-established areas. As pointed out in the above quotation, high supports have also made our wheat non-competitive in world markets thereby encouraging other world producers, such as Canada, Australia, Argentina, and Turkey, to grow more wheat and undersell the United States.

High Supports Headed for Breakdown

When all is said and done, however, the strongest practical argument for flexible supports is the prospect that the high rigid props were headed for breakdown anyway – swamped by the accumulating farm surpluses which they themselves had encouraged.

The piling up of these surpluses under the influence of our various support programs is brought out vividly in the accompanying chart. This traces CCC holdings of, and loans on, farm commodities since the inception of that agency in 1933.



Total CCC Investment in Farm Commodities

It may be recalled that, even before the CCC, the Federal Government, through the Federal Farm Board, was engaging in agricultural price "stabilization" operations in an effort to stem the declines of 1929-32. That experiment cost the Farm Board a large part of its $500 million revolving fund, without success in checking the fall of prices.

With the advent of loans and price support operations under the CCC in the '30s, stocks by the latter part of that decade were already reaching burdensome proportions. This was despite the moderate level of price supports, then at 52 to 75 per cent of parity.

Then came the war and the boosting of price supports to 90 per cent of parity with the view to encouraging maximum production. For a time the insatiable war and postwar needs checked the accumulation of stocks despite high support prices. In fact, the 90 per cent support policy did not come into play during that period, since market demand kept prices above the support levels.

But with the recovery of world agricultural production and subsidence of extraordinary demands, the tendency of CCC stocks to pile up under supports again became manifest. Only the outbreak of the Korean war prevented the situation from becoming acute then. At that time the CCC was bailed out by world buying induced by the outbreak of hostilities.

Now, however, CCC stocks and loans are mounting again, at a pace faster than ever. Already this year they have, as the chart shows, reached an all-time high in excess of $6 billion, and the President has felt compelled to request additional CCC borrowing authority up to $10 billion. With no end in sight, it is inconceivable that the American people would put up indefinitely with a program involving so gigantic a waste of resources.

Basis for Optimism

No one, of course, supposes that flexible supports will alone give the answer to the agricultural problem. That problem has been a long time building up, and will not be solved in a day. With over $6 billion of farm products in storage, there will be need for production and marketing controls over most basic crops until surplus stocks can be reduced to workable levels —which may take several years. Help in finding the answer will come from our rapidly growing population, with its increasing requirements for food and fiber. But essential to any solution must be a return to a flexible price system which gives the right signals for adjusting production to consumption.

With a sound farm program, there appears basis for the optimism expressed by Dr. Karl

Brandt, Associate Director of the Food Research Institute, Stanford University, in a pamphlet "Farm Price Supports— Rigid or Flexible?" recently published by the American Enterprise Association. Looking ahead, he states: "Once the necessary adjustment in the price support policy is made and surpluses are gradually channeled into foreign and domestic consumption, the American farmer will again earn an equitable income based on managerial efficiency and productivity of labor – so long as the industrial economy keeps up a healthy pace of activity and growth – without exorbitant burdens upon all consumers."

Sterling Convertibility with a Small "c"

Talk of convertibility for the British pound and the currencies of other important trading nations is again very much in the air. There is evidence that many countries are now anxious to take this long-awaited step which might extend the system of multilateral trade over the whole area of the Free World, stimulating the exchange of goods and inaugurating a new era of postwar international trade.

At a mid-July meeting of European finance ministers in London, attended also by delegations from the United States and Canada, the discussion centered around the practical problems of a transition to convertibility, the import discriminations and quotas that might be withdrawn simultaneously, and the stand-by credit facilities that could be provided. Committees were assigned to work out recommendations to be presented at the fall meeting of the Council of the Organization for European Economic Cooperation (OEEC).

Meanwhile, the joint annual meetings of the International Monetary Fund and World Bank in Washington, September 24-29, will afford opportunities for finance ministers and central bankers from all over the world to discuss the movement toward convertibility and the help that the Fund's resources can give. The prime purpose of the Fund, it will be recalled, was to remove the abnormal restrictions on international payments and trade that had grown up during the depression and war. Now, as the Fund's 1954 Annual Report on Exchange Restrictions states, "the conditions for convertibility and expansion of multilateral trade have been more progressively and actively prepared than at any time since the Fund was established."

The Randall Commission's Report to the President on Foreign Economic Policy last January reached the same conclusion, approved an approach to convertibility by "gradual and prudent" steps, and stressed the key problem of sterling.

The Sterling Key

The pound sterling has lost a good deal of its luster since the tie to gold was ruptured in 1931 and more particularly over the past fifteen years when holders have been subject to exchange controls which divide sterling into various classes subject to different rules and regulations respecting the uses to which it can be put. But even now sterling is used to finance a very large share of the total trade of the world – about 40 per cent according to the Randall report. Other nations, including some that have gone beyond Britain in liberalizing markets and exchange controls, have felt reluctant or unable to go the whole way except in concert with the pound. In West Germany, which has suffered exchange controls longer than any other country and has been pushing most vigorously toward their abolition, officials have said that they will make the mark convertible "five minutes after the pound".

Convertibility is the ability to exchange one nation's money for another, either at fixed rates set by the government or at fluctuating rates in a free market. The privilege of convertibility is now impaired throughout Europe with the exception of Switzerland. Indeed, in most countries outside the dollar area, exchange controls regulate movements of money from one nation to another, split national currencies into types, and variously impede the holder's access to international markets. At one time people counted as many as 69 kinds of sterling, each with specified limitations as to usage.

Since payment is essential to trade, exchange controls serve broadly to reinforce import quotas, as protection for the balance of payments and domestic producers, and also to discriminate in particular against dollar goods, as an antidote for shortages of dollar exchange. Exchange controls initially came into being under the impetus of the depression and wartime dislocations. They have been perpetuated by difficulties of checking postwar inflation, inertias, desires of administrative bureaucracies to hold their jobs, and desires of home industry to be protected from foreign competition.

The Liberalizing Trend

A definite movement away from exchange controls and inconvertibility is clearly visible, impelled by desires among statesmen to restore the prestige and usefulness of their national currencies and to move away from the unpopular

war-emergency and planned-economy controls which, in any case, were being increasingly evaded. The movement has been part of a broader trend, in one country after another, toward letting people deal in free competitive markets and adjust on their own to changing market conditions. Inflation has been dealt with at its source, by rebalancing government budgets and letting money rates rise to curb borrowing and restimulate saving. Where the ground has been well-prepared, the freedom has brought in its train renewed economic vigor, lending confidence to proceed further.

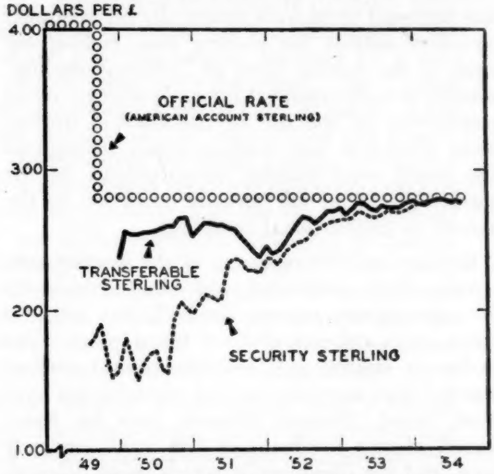
In the peculiarly vital case of Great Britain, discerning economists have realized that the indefinite continuance of controls on use of foreign-held sterling jeopardized the sterling currency area and the historical position of London as an international trade, finance and insurance center. People do not like doing business with a banker who asserts a right to tell them whether or not and for what purposes they can use their money. At the same time, because London is so important, and sterling liabilities are so large, the risk in abolishing exchange controls is correspondingly great. This, however, has not deterred the British authorities from choosing a convertibility goal and, by measured steps, moving toward it.

There is no serious talk in Great Britain of full convertibility — convertibility with a capital "C" — whereby all holders of sterling would be free to spend or send their money anywhere they please in the world. The present goal is to achieve what has been dubbed convertibility with a small "c": in the technical jargon, nonresident convertibility on current account. This would mean freedom on the part of the world at large (nonresidents of the sterling area) to deal in newly-earned sterling free of any restrictions. It would restore to sterling its prewar usefulness in financing world trade, merging the present transferable account and American account pounds into a single international trade pound.

British Moves Toward Convertibility

The initial effort to make sterling convertible, back in 1947, foundered for the reason among others that sterling was not worth in the world markets the officially stated value of $4.03.

The devaluation in September, 1949, of 30 per cent to $2.80, gave an easier footing from which to work. At that time "transferable sterling" (sterling transferable among a specified group of countries) was quoted as low as $2.35. Security sterling (sterling usable by foreigners for buying certain classes of securities) was fluctuating between $1.50 and $2. The chart, giving month-end quotations for these three classes of sterling, shows how rates have pulled together toward the $2.80 official level, most notably since the last "dollar crisis" in 1951. At the same time, the United Kingdom's gold and dollar reserves have accumulated to $3 billion, $1.3 billion above the critical lows of 1949 and early 1952.



Sterling Quotations in New York: American Account, Transferable Account, and Security Sterling

The improvement in rates and accumulation of reserves are all the more striking when one realizes that over this same period the transferable area has been steadily widened, import and rationing restrictions progressively relaxed, dollar exchange granted with increasing readiness, and the reins gradually loosened on the private foreign exchange and commodity markets. The highlights of this slow but sure loosening up of restrictions are worth recording.

A first move toward reactivation of the London foreign exchange market came in December, 1951, when the authorized banks were given permission to buy and sell, for their own account, dollars and certain Western European currencies within specified limits for approved transactions. Previously, such transactions, spot and forward, had been for the official Exchange Equalisation Account operated by the Bank of England. This offered London bankers and specialist houses an invitation to build foreign exchange trading staffs and relearn the arts and techniques of trading on their own responsibility.

A longer step ahead was taken in May, 1953, when Britain, in collaboration with seven other Western European countries, agreed to permit multilateral dealings in their respective currencies. This gave play to arbitrage as a force

evening up exchange rate quotations in the markets concerned. All these actions tended to make sterling more useful outside the dollar area, an end that was also served by the functioning of the European Payments Union and by relaxations of import controls under the encouragement of the OEEC and EPU.

In March, 1954 the transferable sterling area was widened to include practically all nondollar countries outside the sterling area, cutting out most of the special types of "bilateral sterling" subject to individualized rules. Moreover, many restrictions on the use of transferable sterling were abolished and leading banks throughout the world were enabled to participate in the market. Bid and ask spreads narrowed to the benefit of international commerce.

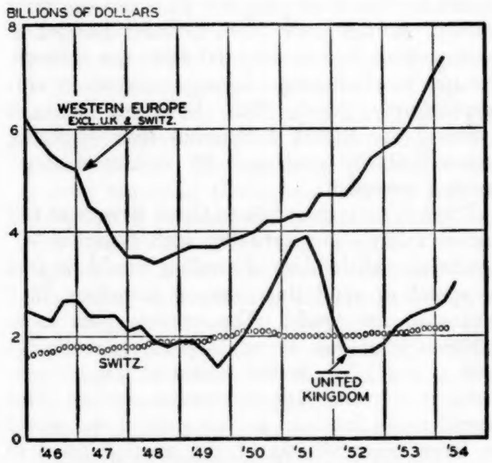
Sterling held by residents of the sterling area remains fully controlled, and blocked balances of nonresidents remain blocked, but even in these areas relaxations have taken place. The exchange control still restricts capital outflow but the rules on withdrawal of capital gains have been eased, blocked balances may be transferred among residents of the same currency area, and the discounts at which these balances can be sold for dollars in the unofficial markets have narrowed.

Hand-in-hand with these steps has come a progressive freeing of trade barriers and commodity markets to the benefit of British consumers and merchants as well as overseas exporters. The aim has been freer trade as well as freer payments. Although about half of British imports from dollar sources still remain under import restriction, imports from Western Europe have been liberalized to a point where 80 per cent of private trade imports flow without restrictive license. International markets have been restored for a growing list of commodities. Many of these markets, including those for wheat, cotton, and gold, remain under special restraints. But it is noteworthy that authorized dealers are now permitted to buy lead, zinc, copper, tin, tungsten, silver and sugar in any currency, including dollars, and to resell for sterling either on the home market or to foreigners. While the purchases place a burden on foreign exchange earnings, resales benefit the demand for sterling.

Basic Factors

Two basic economic developments of the last two years have made possible steps toward convertibility not only in Great Britain but equally in other European nations. One is the progress towards a sounder pattern in their international payments. The reduction or elimination of payments deficits has been made possible by the general expansion of production in company with orthodox fiscal and monetary measures aimed at the control of inflation. Respect for local currencies has improved, the tendency to import in excess has lessened, taxes are being eased, and savings flows are being revived as a noninflationary source for capital expenditure.

The second development is the moderation of the much-advertised and widely-feared American recession. U.S. imports appear to be holding the $10½ billion a year level achieved in each one of the previous four years. Far from reacting to the slow-up here, European business this year is booming and lending strength not only to prices of internationally-traded commodities but also to U.S. export trade, which has improved on commercial account while declining on military account.



Reported Gold Reserves and U.S. Dollar Balances of Western Europe, Quarterly

The build-up of gold and dollar reserves abroad — essential to convertibility at stable rates — has proceeded apace, helped not only by U.S. imports and military outlays abroad but also by diminished absorption of newly-mined gold into hoards. The reserves of Continental Western Europe have risen since 1951 by nearly $3 billion, the largest gains being shown by West Germany, the Netherlands, Austria, Italy and Switzerland. World gold and dollar reserves, outside the United States and exclusive of Russian gold holdings not reported, are estimated to have reached $24 billion, an increase of some $9 billion since the world-wide currency revaluations of September, 1949. In addition, the International Monetary Fund holds more than

$3 billion gold and dollars available to support convertibility programs.

Practical Problems

These developments point to a climax when, it is to be hoped, the principal European nations will end their discriminatory exchange controls, the distinction between American account and transferable account sterling will be abolished, and the European, British Commonwealth and dollar currency areas will be merged into one. The observation has been made that, since transferable account sterling has appreciated practically to the parity of $2.80 for American account sterling, a *de facto* merger of the pound and dollar (for nonresidents on current account) has already been accomplished.

Certainly there is large room for satisfaction in the rise in transferable account sterling as well as in the persistent scarcity of sterling which the British have covered by sales of sterling for dollars. On the other hand, dollar goods are still discriminated against – albeit in diminished degree – and the opening of European and sterling area markets to competition from all sources is a test which has not yet been applied. Moreover, any shock to confidence in sterling, or adverse turn in the British balance of payments, could create a need to support sterling by sales of dollars. Under present-day arrangements a drain of gold and dollars can be limited by tightened discriminations against imports from the dollar area and permitted depreciation of transferable sterling. These devices would have to be forsworn if convertibility were to have real and enduring significance.

There are two ways – both in harmony with a liberal trade approach – in which this risk can be covered, assuming a pursuance by Britain of constructive and sound fiscal and credit policies. One way is to have a floating pound for a transitional period and to let the pound depreciate if necessary to discourage excessive imports, encourage exports, penalize speculative conversions into dollars, and protect the reserves from sudden and abnormal depletion. The exchange risks would inconvenience trade and perhaps also deter foreigners from carrying idle funds in London. A floating pound also would tend to leave the world compartmentalized, as in the 1931-39 period, into dollar and sterling blocs. But if a floating pound is the only safe route for regaining convertibility, these disadvantages might be tolerable. Certainly it is better to have one fluctuating pound than a confusing mass of noninterchangeable types such as grew up under the exchange controls.

Stand-by Credits

Apart from the possibility that the unified pound could fluctuate, perhaps within a stated range of movement, there is the question of resources to defend the lower limit, now $2.78 on American account sterling. As noted earlier, the United Kingdom gold and dollar reserves, rising steadily, are now up to $3 billion. This is not all. The United Kingdom is repaying $112 million borrowed from the International Monetary Fund and thus clearing the slate for a special line of credit with the Fund. The United Kingdom's annual drawing limit, as set up in the Fund's statutes, is $325 million, but the Executive Directors may authorize a larger credit line if they are satisfied that conditions are ripe and over-all resources ample. Of the Fund's total gold and dollar resources, exceeding $3 billion, $1 billion would not be an excessive allocation, considering the key importance of sterling convertibility to world trade and finance and the need to reserve lines of credit for other countries wishing to undertake convertibility.

As the Randall report points out, a second means of strengthening reserves lies in the power of the Federal Reserve System to enter into line of credit arrangements with foreign central banks. The report states that:

> There is ample precedent for such arrangements in the interwar period; and the Commission believes that this method is superior to any other which might be devised to provide for additional possible calls on dollars, both because it would avoid an increase in the public debt and because it could be handled more flexibly and informally, and therefore more effectively, than a formal grant of credit by our Treasury.

The advantage of having large resources at hand is that they dispel doubts that enough dollars will be available to maintain convertibility. The plain fact is that a currency is more valuable and desirable when it is convertible than when it is not. The general experience is that people do not hasten to convert when they know that a sound basis has been laid and that adequate resources are at hand to maintain the privilege of conversion.

As Professor Gottfried Haberler of Harvard University has stated:

> Anyone who cares to learn from recent history should realize that currency convertibility depends primarily on proper monetary, financial and economic policy. If liberal economic and prudent financial policies are pursued, even the most serious material war damage can be repaired in a few years. However rich a country, its balance of payments can be ruined and the stability of its currency jeopardized almost over night by lax financial policies.*

* "Currency Convertibility" published by the American Enterprise Association, 1954.